Microsoft Corporation

1986

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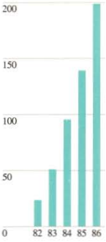
1986 Annual Report

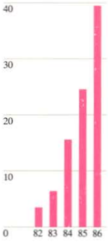
Financial Highlights

(In thousands, except net income per share)	1986	1985	1984	1983	1982
	Year Ended June 30,				
For the Year:					
Net revenues	197,514	140,417	97,479	50,065	24,486
Net income	39,254	24,101	15,880	6,487	3,507
Net income per share	1.56	1.04	0.69	0.29	0.17
Average shares outstanding	25,200	23,260	22,947	22,681	21,240
At Year-End:					
Working capital	118,452	41,442	21,458	9,024	4,994
Total assets	170,739	65,064	47,637	24,328	14,784
Stockholders' equity	139,332	54,440	30,712	14,639	8,299
Key Ratios:					
Current ratio	5.0	4.9	2.3	1.9	1.8
Return on net revenues	19.9%	17.2%	16.3%	13.0%	14.3%

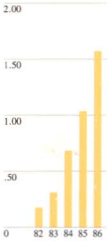
Net Revenues
(In millions)



Net Income
(In millions)



Net Income Per Share



Welcome to Microsoft's first annual report.

This year has been a successful one. Revenues topped $197.5 million, a 41% increase from last year. Net income equalled $39.3 million, up 63% over fiscal 1985. Net income per share was $1.56, up 50% over last year.

These positive results reflect the hard work of our employees and the continuing popularity of our products. But the numbers tell only part of the story. In this year of achievement, we have taken important steps to strengthen our product lines and to position our Company for the future.

We made the initial public offering of our stock in March, raising $45 million. Just prior to the offering, we moved our corporate offices to a new 29-acre location in Redmond, Washington, consolidating management operations at a single site while giving us room for future expansion.

We introduced several key products for MS-DOS®-based computers (such as the IBM® PC) and for Apple® Macintosh™ systems, securing our role as a leading supplier of software for both architectures.

Microsoft® Excel, a spreadsheet integrated with business graphics and database capabilities, was introduced in September 1985. It quickly became the top-selling application for the Macintosh, a market position it maintains today.

In November we brought out the Microsoft Windows operating environment. Windows allows customers to run multiple programs simultaneously, while providing a common, graphics-based foundation for the next generation of applications software. Since introduction, more than 500 developers have said that they plan to develop applications products that will run under Microsoft Windows.

In April 1986 we introduced Version 3.0 of Microsoft Word for IBM Personal Computers and compatibles. This newest version of our successful word processing program includes a built-in outline processor, as well as extended support for the latest high-resolution laser printers. A version of Microsoft Word designed specifically for local area networks was also introduced.

In addition, several other products were significantly enhanced, including the MS-DOS versions of the Microsoft Multiplan® spreadsheet, the Microsoft Chart business graphics program, the Microsoft Project scheduling and resource allocation program, the Microsoft Mouse pointing device, and the Microsoft QuickBASIC and Microsoft C Compiler languages. Version 3.2 of the MS-DOS operating system and Version 5.0 of the XENIX® 286 operating system were released to hardware manufacturers for distribution to their customers. And we entered what is for us a new product category—electronic communications—with the introduction of the Microsoft Access business information-access program.

In the same way that we have expanded and enhanced our product line over the past year, we have also expanded our reach internationally. Our activities outside the United

Jon A. Shirley   William H. Gates

States have increased at a rapid pace, generating revenues of $80 million, which represents more than 40% of our business.

To foster continued growth in overseas markets, we have taken several steps to strengthen our international organization. For example, we opened sales offices in Italy, Sweden, and the Netherlands; and we transferred Japanese operations from ASCII, an exclusive sales representative, to Microsoft KK, a wholly owned subsidiary.

We opened a manufacturing facility in Dublin, Ireland, to provide packaged products to Europe. And we have begun to handle international distribution of products produced by other software publishers.

This past year has also ushered in a new era of technological development for our Company. We believe that many of the technologies on the horizon will significantly increase the productivity of microcomputer users. Over the next year, we will research and develop products that will allow customers to put these technologies to work.

We are creating advanced systems software to take advantage of the power and speed of the Intel® 80286 and 80386 microprocessors. Similarly, the increasing popularity of local area networks makes it possible for us to build sophisticated capabilities into our software products, while presenting us with new pricing and distribution challenges.

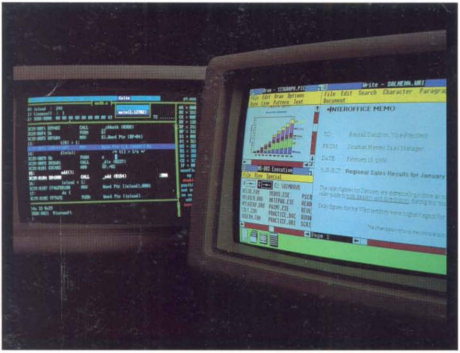
During the past year, we have also established a Research and Development group to pursue opportunities in CD ROM (Compact Disc Read Only Memory) technology. A CD ROM disc can contain a thousand times more information than a standard floppy disk, making it an important technology for the future. Because of that, Microsoft is striving to be a leader in developing CD ROM products. Although this technology has the potential to create an entirely new market of personal computer applications, we do not expect any revenues from it during the coming year.

In summary, we look to the year behind us as a year of achievement, while looking ahead to a year of growth and development. We expect continued growth through the next twelve months, fueled primarily by domestic and international retail operations. The 20% profit margin of fiscal 1986 is probably not sustainable, especially in this period of heavy R&D expenditures. But we do believe that we can achieve margins that are in line with our historical results.

Our mission as a company is to bring the benefits of microcomputer technology to the greatest number of people. What we do this year will be essential to that mission, to our long-term financial growth, and to our ability to maintain technical and marketing leadership.

Jon A. Shirley
President
and Chief Operating Officer

William H. Gates
Chairman of the Board
and Chief Executive Officer



Microsoft, the first microcomputer software company, was at the hub of the personal computer industry from the start.

We introduced the first BASIC language for the first personal computer in 1975. Today, Microsoft BASIC runs on more than eight million machines.

We taught the IBM Personal Computer how to think, by supplying the MS-DOS operating system. Today, we are working directly with more than 300 hardware manufacturers who provide MS-DOS to their customers.

Shown above are two of our newest system/language products—Microsoft Windows in the foreground, with the Microsoft CodeView™ debugger in the background.

The year is 1975. Small teams of people, working in a few start-up operations, are about to forge a new industry. It is an industry that will revolutionize the way that business does business, by bringing the power of computers to offices and homes all around the world.

Microsoft, the first software company dedicated to microcomputer products, was one of those pioneers. Recognizing that the first priority in this new market was to give people a way to control their computers, we developed the BASIC language for the first generation of machines, including the MITS Altair, Apple II, Commodore, and Tandy personal computers. We followed with additional language products during the next few years.

Then, in 1981, the promise of this young industry blossomed with the introduction of the IBM Personal Computer. Microsoft supplied the IBM PC with the software that taught it how to think, the MS-DOS operating system.

Today, five years later, MS-DOS is still the dominant operating system for the IBM PC family and its many compatibles. Microsoft markets a diverse line of more than 40 software products, including operating systems, languages, and a growing number of applications programs. And our financial results make us one of the leading microcomputer software companies.

The Company

Microsoft is dedicated to producing the best possible software by taking advantage of new technologies that allow us to open new market opportunities.

We have a broad line of products built on that philosophy, and several well-established channels for getting those products to customers.

The Company is organized into key operating groups: product groups—Systems/Languages Software, Applications Software, Books, and Hardware; and distribution groups—OEM (Original Equipment Manufacturer) Sales, Retail Sales, International Operations, and Microsoft Press.

Viewed from either perspective, our marketing efforts are well balanced. In the product groups, for instance, a snapshot of this year's revenues looks like this:

Systems/Languages	53%
Applications	37
Hardware and Books	10

And when viewing channels of distribution, this year's revenues are divided as follows:

Domestic OEM	25%
Domestic Retail	32
International OEM	21
International Retail	19
Microsoft Press	3

Operating Systems and Environments

Since the introduction of MS-DOS on the IBM PC in 1981, we have created versions of it for more than 300 other computers, enhancing it as new opportunities and needs have arisen. Recent changes in MS-DOS, for example, include additional support for local area networks and support for the 3.5-inch disk format introduced on the IBM PC Convertible.

This past year we introduced Microsoft Windows, an operating environment that runs under the MS-DOS operating system. Microsoft Windows allows customers to run several programs at the same time. It works with standard programs that are already on the market and provides a foundation for the next generation of graphics-based applications.

These graphics-based applications use drop-down menus, icons, and mixed text and graphics to give the user a natural, intuitive way to interact with the computer. They represent a major step forward in software technology—making computers easier to use while allowing developers to bring sophisticated new capabilities to their programs.

In our own software efforts we have seen how Windows can save development time, since a programmer is able to focus on the *content* of a program rather than spending time on procedures that Windows controls. We are actively encouraging development of Windows-based programs by other companies. Already, more than 500 developers—including several industry leaders—have said that they intend to develop products that will run under Microsoft Windows. Additionally, the United States Air Force, in a major computer purchase from Zenith Corporation, has specified that Microsoft Windows be supplied with each system.

Microsoft markets other systems products as well, including the first multi-user tools for microcomputers: the XENIX operating system and Microsoft Networks. As the use of networks becomes more prevalent in business, these tools for linking computers—while linking people to centralized stores of information and devices—will become increasingly important.

Languages

Our line of language products has expanded as we have grown. We now offer both interpreted and compiled versions of Microsoft BASIC, as well as Microsoft C Compiler, FORTRAN Compiler, COBOL Compiler, Pascal Compiler, and Macro Assembler. These languages are available for the MS-DOS or XENIX operating systems, and Microsoft BASIC and FORTRAN are available for Apple Macintosh.

During this past year, we introduced our latest BASIC product for MS-DOS systems—Version 2.0 of Microsoft QuickBASIC Compiler—bringing improved performance and a friendly user interface to this popular language. And we completed development on an updated version of our Microsoft C Compiler, introducing with it a graphics-oriented debugger called Microsoft CodeView.

Each of our language products offers particular advantages to different segments of the market, from casual programmers to professional developers. Combined, they give programmers a powerful selection of tools for creating a wide variety of specialized applications.

The OEM Business

Currently, we have technical and business relationships with approximately 300 hardware manufacturers—among them, IBM, COMPAQ, AT&T, Tandy, Olivetti, Zenith, Wang, Hewlett-Packard, DEC, NEC, Epson, Siemens, Philips, and Mitsubishi.

These hardware manufacturers—known as Original Equipment Manufacturers or OEMs—distribute Microsoft systems or language products with their hardware. Microsoft licenses to an OEM the right to make copies of our software and to distribute those copies with the OEM's computer. The OEM generally pays an initial commitment fee, along with an additional fee based on how many copies of the product it makes or on how many computers it ships.

The scope of these technical and business relationships with all the major OEM companies puts us at the hub of our industry, giving us a special perspective on the future directions of our business. In turn, we are able to incorporate that perspective into our products, and to create products that can better serve our customers.

Applications Software

In 1982 we recognized the growing importance of business customers in the microcomputer market. Building on our established expertise in system/language products, we introduced our first business productivity program—the Microsoft Multiplan spreadsheet.

Since then, more than a million copies of Multiplan have been distributed around the world. It is available for more than 70 brands of microcomputers and in more than a dozen foreign languages.

And today Multiplan is just one of a long line of applications products. We offer an extensive selection of business productivity tools designed for use by many types of customers.

Category	Product	MS-DOS version	Macintosh version
Word processing	Microsoft Word	■	■
Spreadsheet	Microsoft Multiplan	■	■
	Microsoft Excel		■
Business graphics	Microsoft Chart	■	■
File management	Microsoft File		■
Project management	Microsoft Project	■	
Communications	Microsoft Access	■	

This line of applications products covers a broad range of business needs, in both the MS-DOS and Macintosh environments. Sales in both environments are strong, and we are particularly strong in the Macintosh arena.

Our productivity products are designed for "in-depth users"—people who need the advanced capabilities that are possible with comprehensive, feature-rich programs. Since most of our customers spend most of their time using one main program, they do not want to compromise that primary application.

Microsoft introduced its first applications program, the Microsoft Multiplan spreadsheet, in 1982.

Today we market a wide range of applications for both MS-DOS-based and Apple Macintosh computers, including word processors and spreadsheets, and programs for business graphics, communications, and project management.

We are continually enhancing these products, taking advantage of the latest advances in technology. Our newest version of Microsoft Word, for example, includes built-in outline processing as well as support for the latest generation of laser printers.

Domestically, we distribute these products through major independent distributors, dealership chains, and through direct marketing efforts. Internationally, we distribute domestic and foreign-language versions of products through subsidiaries and independent sales representatives.

Consider the advanced features that are built into our new edition of Microsoft Word released in April. Microsoft Word 3.0 is designed for serious word processor users—from educators to lawyers to writers to anyone who produces a lot of written text. It includes a full selection of word processing tools that provide help at every stage of writing, from developing ideas to creating finished pieces. The built-in outline processor, for example, lets a customer start work on a document by getting thoughts down in an outline, and then later transform that outline into a final report. Microsoft Word is also one of the first word processors to provide high-level support for the typeset-like printouts that are possible with the newest laser printers—and that support was built into this product *before* those printers became widely available.

Retail Distribution

Microsoft's product line is distributed through independent distributors and dealers, as well as through our own direct marketing efforts.

Domestic distribution is handled through four leading software distributors along with major dealership chains. Internationally, retail distribution is managed through the subsidiary or exclusive sales representative with responsibility for the region.

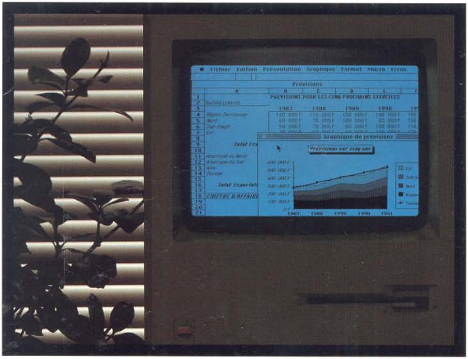
Microsoft has also established a National Accounts Group, which coordinates efforts with key dealers to serve corporate customers, as well as a similar group that works with value-added resellers to market products to various government agencies. And we have contracts to supply applications and language products to many universities, who use these products in their own operations as well as marketing them to students, professors, and employees.

Hardware and Books

Although software products account for the greatest portion of our business, we also market hardware and books that are designed to help customers get more out of that software and more out of their computers.

The Microsoft Mouse, a handheld pointing device that works on MS-DOS-based systems, is the Company's principal hardware product. It gives users a natural way to select commands and move around the screen, and works with many products from Microsoft and other companies.

Microsoft Press, our book-publishing arm, has published nearly 40 titles that give practical, hands-on information about our software, along with general-interest books for those who want to learn more about computers and the computer industry. Among our most popular titles are *Running MS-DOS* by Van Wolverton, *The Peter Norton Programmer's Guide to the IBM PC* by Peter Norton, and *The Apple Macintosh Book* by Cary Lu. Microsoft Press books are distributed through traditional book trade outlets and through computer stores.



More than 40% of Microsoft revenues come from our international operations.

We intend to build on that success by solidifying our position in the growing international market for personal computers.

This international presence is of increasing importance to many of our customers as they equip their facilities around the world with office information systems. Products such as Microsoft Excel (French version shown above) are available in local-language versions that are appropriate for international uses.

To serve the international market, Microsoft has established foreign subsidiaries and sales offices, and operates a manufacturing facility in Ireland to serve Europe.

A Strong International Presence

Microsoft has built its international business on some important commitments.

We want, whenever possible, to be in *the countries we serve, with products localized to each country's language and standards.*

We insist on maintaining the same high quality-controls in our international products that we demand in domestic versions.

And we want to provide active support to the marketing efforts of our overseas distributors and dealers.

These commitments have paid off. Last year, more than 40% of revenues—$80 million—came from our international operations. Next year, we expect another strong showing in international revenues as these markets continue to evolve.

We have set up subsidiaries in Canada, England, France, West Germany, Japan, Australia, Italy, Sweden, and the Netherlands. In other parts of the world, Microsoft is represented by independent sales representatives.

The leading source of revenues in Europe, Canada, and Australia has come from our retail operations. OEM distribution has been responsible for a greater percentage of revenues in the Far East and other regions.

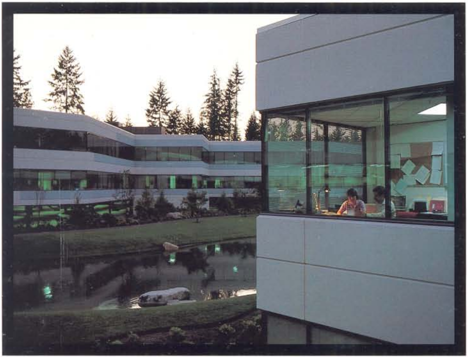
Localized Products

In December 1985 we started operations in a new manufacturing facility in Dublin, Ireland, primarily to serve the European retail market. This Dublin facility has proven that it is able to meet the same stringent quality-control requirements that we insist upon in the United States.

More than 110 local-language versions of our products are currently available. This means that user messages in each program and all documentation is in the native language, special characters are supported on the screen, and local conventions—such as dates and monetary references—are handled correctly. Both the Microsoft Windows and the Macintosh programming environments have a technical design made specifically with international localization in mind. As we develop more applications in these environments, our time-to-market of localized software will be accelerated.

This past year we also obtained international distribution rights for products produced by other United States companies, including Microrim and Micrografx. Internationally, their products carry the Microsoft name, and we provide worldwide marketing and support for them.

These international strengths are of importance to our marketing efforts. But we believe that these strengths are also of increasing importance to our corporate customers—both domestically and internationally—as they start equipping their facilities around the world with office information systems. By establishing our international presence today, we will be able to provide a high level of support to meet the future computing needs of these corporations.



Today, more than 1100 Microsoft employees are working together toward a common goal: to bring the benefits of the latest technology to our customers.

To better understand the needs of those customers, we use our own applications and networking products every day in our work.

This first-hand experience pays off in our development efforts, allowing us to identify exactly what kinds of features make sense to the market.

More than 300 Microsoft people are engaged full-time in software development, and we spend 10.4% of net revenues on creating and enhancing products.

The People of Microsoft

Behind our products are more than 1100 Microsoft employees dedicated to a single purpose: to bring the benefits of today's latest technology to customers.

In our quest to find the best employees, we have carefully monitored our growth, preferring to hire higher-quality people instead of higher numbers of people. In order to attract the most talented employees, we give them room to be creative and reward them well for working hard.

The rapid pace of our industry makes it essential to get products to market in a timely manner and to respond quickly to technological change.

Because of this, we have put together a highly trained team of technical personnel who are responsible for creating new products. Currently, more than 300 people are engaged full-time in software development. We spent $20.5 million on product development and enhancement last year, a total that represents 10.4% of net revenues.

Most products are developed internally by our programmers, which gives us close control over technical development. Our programming staff is working with a substantial collection of proprietary development tools that make it possible for us to transfer our technology from one product to another. This means lower-cost development and faster time-to-market, and gives us the ability to move software onto different machines.

The people of Microsoft are committed to understanding what our customers need, so that we can include features that make sense in our products. Most Microsoft employees use our products every day in their work. The entire company is networked on a XENIX-based electronic mail system. And, to make sure that we stay closely in touch with the particular needs of our end users, we have established a Product Support group that is able to answer up to 35,000 phone calls a month.

Opportunities Ahead

We believe that our talented employees and technical capabilities put us in a strong position to make the most of the opportunities that lie ahead—opportunities to create products that meet the next generation of customer needs brought about by the availability of technologies like the following.

Intel 80286 and 80386 microprocessors

Intel's new microprocessors herald the next generation of microcomputers. We are creating system software that takes advantage of the protected mode of the Intel 80286, which is the microprocessor that is built into the IBM PC AT. Intel's 80386 will be able to run even faster and support larger memories. We are currently working on new versions of the MS-DOS and XENIX operating systems to take advantage of these capabilities.

The availability of this new technology does not just mean that people will want to run bigger programs, but that the very nature of those programs will change. Some of the machines

Our corporate mission is to create software that makes the microcomputer a valuable tool on every desk and in every home.

Our product strategy to meet that mission is to take the latest advances in technology and to match them to the specific needs of our customers.

We continue to work at the forefront of the opportunities made possible by the latest technologies, including the exciting possibilities of CD ROM technology (CD ROM discs shown above).

These efforts, we believe, will allow us to maintain growth and are essential if we are to maintain a leadership role in the industry.

using the 80386, for example, may be designed for multi-user applications, with several people using terminals on a single central computer. And the additional memory will also make it easier for customers to run more programs simultaneously, transferring information directly from one to another as needed.

Networking

As more companies equip more people with computers, they begin to look for ways to improve the information exchange between machines. The answer for many companies: local area networks, which link computers so that they can exchange data and use common files. Many people expect local area networking to be one of the fastest-growing segments in our industry, especially since key players such as IBM have now revealed parts of their networking strategies.

The increasing popularity of networks is changing the old rules about "one person, one computer, one program," since many users can now share the same copy of a program on a centralized network. So while the wider availability of networks allows us to build exciting new capabilities into our products, it also presents us with new challenges for pricing and distributing our network software.

With our announcement this past year of the network version of Microsoft Word, we became one of the first companies to take those challenges head on, producing a specialized version of the product that allows customers to lock information, work from common files, and share common devices such as printers.

Computer-Based Training

We are committed to giving our customers the tools they need to make the most of our software, such as manuals, on-screen help, and disk-based tutorials. All of these work together, meeting the needs of different customers at various stages in the learning process.

The last of those tools—computer-based training or CBT—is an essential element in that mix, and one of growing importance in our product strategy. The notion is logical: that a program should be able to teach you, right on the screen, how to use its features. We have made an investment in this learning technology, hiring a team of experienced instructional designers and programmers and equipping them with state-of-the-art authoring tools.

Their work has been well received, judging from the reactions of the press and of our customers to the CBT programs included with Microsoft Word and Microsoft Project.

Graphical User Interface

We believe that a graphical user interface, such as Microsoft Windows, gives customers a more natural, intuitive way to approach computing. Instead of learning complicated commands, the customer only has to learn one way of doing things—the Windows way. For companies, this can reduce training time and make computers more useful to more people.

Graphical user interfaces also make it possible to create documents that combine text with graphic images for more effective presentation.

Microsoft is committed to developing future applications products that will take advantage of the research and work we have done in creating the Windows graphical user interface. Up to now, hardware has limited our ability to do this. But with hardware technology coming down in price, the cost of effectively implementing these graphical interfaces is coming down, too.

CD ROM

CD ROM (Compact Disc Read Only Memory) is a new technology that has already had a major impact in the recording industry, where it has become an alternative to records. CD music players are selling for less than $200, which leads us to believe that the computer applications of this technology will also be very affordable.

In computer applications, a single CD ROM disc can contain a thousand times more information than a standard floppy disk. It can also allow multi-media presentations combining text, video, and audio.

Microsoft has set up an advanced research and development group dedicated to CD ROM. And in March we sponsored a major conference on CD ROM technology, with nearly 1000 people in attendance from the publishing and computer industries.

We foresee that CD ROM can be used in a large number of ways—for database storage, as a software distribution medium, for electronic publishing of books and documentation, and for mass storage of fonts or images. Future CD ROM applications might include everything from electronic encyclopedias to medical databases to home entertainment products.

Taken together, these new technologies offer exciting possibilities that will allow us to continue moving forward in our mission as a company—to make the microcomputer a valuable tool on every desk and in every home.

By building on our foundation in products and distribution, and by capitalizing on new technological opportunities like those described above, we intend to continue our financial success as a corporation, and maintain our leading role in the growth of our industry.

This is how we have been successful up to now. This is how we plan to continue that success into the future.

Selected Five-Year Financial Data

(Dollars and shares in thousands, except per share data)	1986	1985	Year Ended June 30, 1984	1983	1982
For the Year:					
Net revenues	197,514	140,417	97,479	50,065	24,486
Cost of revenues	40,862	30,447	22,900	15,773	8,647
Research and development	20,523	17,108	10,665	7,021	3,597
Sales and marketing	57,668	42,512	26,027	11,916	4,009
General and administrative	17,555	9,443	8,784	4,698	3,037
Income from operations	60,906	40,907	29,103	10,657	5,196
Non-operating income (loss)	5,078	1,936	(1,073)	407	399
Income before income taxes	65,984	42,843	28,030	11,064	5,595
Provision for income taxes	26,730	18,742	12,150	4,577	2,088
Net income	39,254	24,101	15,880	6,487	3,507
Capital expenditures	14,108	6,576	5,837	3,230	1,832
Depreciation	5,754	3,462	2,068	1,007	435
At Year-End:					
Current assets	147,980	52,066	37,947	18,713	11,479
Net property, plant and equipment	19,544	11,190	8,076	4,307	2,084
Other assets	3,215	1,808	1,614	1,308	1,221
Total assets	170,739	65,064	47,637	24,328	14,784
Current liabilities	29,528	10,624	16,489	9,689	6,485
Long-term liabilities	1,879	—	436	—	—
Stockholders' equity	139,332	54,440	30,712	14,639	8,299
Total liabilities and equity	170,739	65,064	47,637	24,328	14,784
Working capital	118,452	41,442	21,458	9,024	4,994
Number of employees	1,153	910	608	367	151
Common Stock Data:					
Net income per share	1.56	1.04	0.69	0.29	0.17
Book value per share	5.46	2.53	1.44	0.67	0.38
Cash and short-term investments per share	4.02	0.88	0.15	0.15	0.05
Average shares outstanding	25,200	23,260	22,947	22,681	21,240
Shares outstanding at year-end	25,520	21,533	21,260	21,832	21,831
Key Ratios and Percentages:					
Current ratio	5.0	4.9	2.3	1.9	1.8
Return on net revenues	19.9%	17.2%	16.3%	13.0%	14.3%
Return on average total assets	33.3%	42.8%	44.1%	33.2%	34.6%
Return on average stockholders' equity	40.5%	56.6%	70.0%	56.6%	62.1%
Growth percentages—increases:					
Net revenues	40.7%	44.0%	94.7%	104.5%	—
Net income	62.9%	51.8%	144.8%	85.0%	—
Net income per share	50.0%	50.7%	137.9%	70.6%	—
Book value per share	115.8%	75.7%	114.9%	76.3%	—

Results of Operations

The following table sets forth consolidated results of operations as a percentage of net revenues and the annual percentage change in such results.

	Percentage of Net Revenues Year Ended June 30,			Percentage Change Year Ended June 30,	
	1986	1985	1984	1985 to 1986	1984 to 1985
Net revenues	100.0%	100.0%	100.0%	40.7%	44.0%
Costs and expenses:					
Cost of revenues	20.7	21.7	23.5	34.2	33.0
Research and development	10.4	12.2	10.9	20.0	60.4
Sales and marketing	29.2	30.3	26.7	35.7	63.3
General and administrative	8.9	6.7	9.0	85.9	7.5
Total costs and expenses	69.2	70.9	70.1	37.3	45.5
Income from operations	30.8	29.1	29.9	48.9	40.6
Non-operating income (loss)	2.6	1.4	(1.1)	162.3	280.4
Income before income taxes	33.4	30.5	28.8	54.0	52.8
Provision for income taxes	13.5	13.3	12.5	42.6	54.3
Net income	19.9%	17.2%	16.3%	62.9%	51.8%

Net revenues for the years ended June 30, 1986, 1985, and 1984 were $197.5 million, $140.4 million, and $97.5 million. These amounts represented growth of 40.7%, 44.0%, and 94.7% for the respective years. The annual increases in the Company's net revenues have resulted from several factors, including the introduction of new products and enhancements to existing products, the expansion of the Company's export sales and foreign operations, and the general expansion of the market for microcomputer software. Significant product introductions in fiscal 1986 included Microsoft Multiplan 2.0, Microsoft Chart 2.0, and Microsoft Word 3.0 for IBM Personal Computers and compatibles; Microsoft Excel and Microsoft Flight Simulator for the Apple Macintosh; Microsoft Windows operating environment; and Microsoft Mouse 5.0. Product introductions in fiscal 1985 included Microsoft Word 2.0 for IBM Personal Computers and compatibles and Microsoft Word, Microsoft File, and Microsoft Business Pack for the Apple Macintosh.

International net revenues for the years ended June 30, 1986, 1985, and 1984 were $80 million, $44.6 million, and $29.5 million. These amounts represented 40.5%, 31.8%, and 30.2% of total net revenues for the respective years. This growth resulted from several factors, including successful product localization, contribution of additional foreign subsidiaries, and favorable currency exchange rates for fiscal 1986. For additional information concerning export sales and foreign operations, see Note 7 of Notes to Consolidated Financial Statements.

Cost of revenues as a percentage of net revenues has remained fairly stable during the three years presented. The decrease in fiscal 1985 to 21.7% of net revenues from 23.5% the prior year was principally the result of a shift in the sales mix from lower-margin hardware products to higher-margin software products.

Research and development expense for the years ended June 30, 1986, 1985, and 1984 was $20.5 million, $17.1 million, and $10.7 million. Research and development expenses have increased as a result of planned software development staff increases and expenditures to create development tools. Management presently anticipates that research and development expenses will continue to increase primarily as a result of further planned software development staff increases and CD ROM efforts.

Sales and marketing expense for the years ended June 30, 1986, 1985, and 1984 was $57.7 million, $42.5 million, and $26 million. Sales and marketing expenses have increased as a result of (i) expanding the Company's domestic and international sales and marketing staff, (ii) opening of local, regional, and international sales facilities, (iii) higher advertising and related expenditures, and (iv) increases in the provision for doubtful OEM accounts, primarily in 1985.

During 1986, 1985, and 1984, the Company's general and administrative expenses were $17.6 million, $9.4 million, and $8.8 million. The increase in general and administrative expenses is attributable to several factors, including the growth in administrative staff and functions necessary to support the Company's increased sales volume and the Company's move to new corporate facilities in Redmond, Washington, in March 1986.

Non-operating income for the years ended June 30, 1986 and 1985 was $5.1 million and $1.9 million. During 1984 the Company had a net non-operating loss of $1.1 million. Non-operating income (loss) includes interest income of $3.2 million, $1.0 million, and $400,000 for the years ended June 30, 1986, 1985, and 1984. The growth in interest income is attributable to a larger investment portfolio resulting from funds generated from operations and proceeds of $44.8 million from the Company's initial public offering in March 1986. The 1986 results also include a foreign currency transaction gain of $2 million resulting primarily from the repayment of debt from certain international subsidiaries. In 1985 the Company realized a short-term capital gain of $1 million upon the sale of marketable equity securities, and in 1984 the Company realized a short-term capital loss of $1.5 million from the write-off of the entire value of a minority interest in a closely held company.

The effective tax rates for fiscal 1986, 1985, and 1984 were 40.5%, 43.7%, and 43.3%. For an analysis of the differences between the statutory and the effective income tax rates, see Note 4 of Notes to Consolidated Financial Statements.

Liquidity and Capital Resources

In March 1986 the Company sold 2.3 million shares of common stock in its initial public offering. The Company's proceeds, net of expenses, totaled $44.8 million. Prior to its public offering the Company had funded its activities almost entirely from funds generated from operations. The Company's cash and short-term investments balance at June 30, 1986 was $102.7 million.

Consolidated Balance Sheets

	Ending ↓	Beginning ↓
	June 30,	
(In thousands, except share data)	1986	1985
Assets		
Current assets:		
Cash and short-term investments	$102,676	$18,948
Trade accounts receivable—net of allowance for doubtful accounts of $4,060 and $2,288	34,499	25,273
Inventories (Note 2)	8,008	5,919
Other	2,797	1,926
Total current assets	147,980	52,066
Property, plant and equipment—net (Notes 3 and 5)	19,544	11,190
Other assets	3,215	1,808
	$170,739	$65,064
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 6,842	$ 2,497
Customer deposits	6,951	2,757
Royalties and commissions payable	2,929	1,315
Income taxes payable (Note 4)	7,472	1,251
Other	5,334	2,804
Total current liabilities	29,528	10,624
Long-term portion of capital lease obligations (Note 5)	1,879	—
Commitments and contingencies (Notes 3, 4, 5, and 8)		
Total liabilities	31,407	10,624
Stockholders' equity (Note 6):		
Convertible preferred stock—$.01 par value; 500,000 shares converted to 1,000,000 shares of common stock upon completion of the public offering in March 1986	—	5
Common stock—$.001 par value; shares authorized 60,000,000; issued and outstanding 25,519,981 and 21,533,353	26	22
Paid-in capital	50,792	5,101
Retained earnings	89,228	49,974
Translation adjustment	(714)	(662)
Total stockholders' equity	139,332	54,440
	$170,739	$65,064

See accompanying notes.

Consolidated Statements of Income

(In thousands, except net income per share)	Year Ended June 30, 1986	1985	1984
Net revenues	$197,514	$140,417	$97,479
Costs and expenses:			
Cost of revenues	40,862	30,447	22,900
Research and development	20,523	17,108	10,665
Sales and marketing	57,668	42,512	26,027
General and administrative	17,555	9,443	8,784
Total costs and expenses	136,608	99,510	68,376
Income from operations	60,906	40,907	29,103
Non-operating income (loss) (Note 1)	5,078	1,936	(1,073)
Income before income taxes	65,984	42,843	28,030
Provision for income taxes (Note 4)	26,730	18,742	12,150
Net income	$ 39,254	$ 24,101	$15,880
Net income per share	$ 1.56	$ 1.04	$ .69
Average shares outstanding	25,200	23,260	22,947

See accompanying notes.

Consolidated Statements of Stockholders' Equity

(In thousands, except share data)	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Paid-In Capital	Retained Earnings	Treasury Stock Shares	Treasury Stock Amount	Translation Adjustment	Total Stockholders' Equity
Balance, June 30, 1983	500,000	$ 5	21,831,566	$22	$ 5,339	$ 9,993	(997,366)	$(732)	$ 11	$ 14,638
Sale of stock to employees	—	—	426,027	—	26	—	—	—	—	26
Retirement of treasury stock	—	—	(997,366)	(1)	(732)	—	997,366	732	—	(1)
Amortization of deferred compensation	—	—	—	—	240	—	—	—	—	240
Net income for fiscal year 1984	—	—	—	—	—	15,880	—	—	—	15,880
Translation adjustment	—	—	—	—	—	—	—	—	(71)	(71)
Balance, June 30, 1984	500,000	5	21,260,227	21	4,873	25,873	—	—	(60)	30,712
Sale of stock principally to employees	—	—	273,126	1	145	—	—	—	—	146
Amortization of deferred compensation	—	—	—	—	83	—	—	—	—	83
Net income for fiscal year 1985	—	—	—	—	—	24,101	—	—	—	24,101
Translation adjustment	—	—	—	—	—	—	—	—	(602)	(602)
Balance, June 30, 1985	500,000	5	21,533,353	22	5,101	49,974	—	—	(662)	54,440
Sale of stock in initial public offering	—	—	2,300,000	2	44,837	—	—	—	—	44,839
Conversion of preferred stock	(500,000)	(5)	1,000,000	1	4	—	—	—	—	—
Sale of stock principally to employees	—	—	686,628	1	850	—	—	—	—	851
Net income for fiscal year 1986	—	—	—	—	—	39,254	—	—	—	39,254
Translation adjustment	—	—	—	—	—	—	—	—	(52)	(52)
Balance, June 30, 1986	—	—	25,519,981	$26	$50,792	$89,228	—	—	$(714)	$139,332

See accompanying notes.

Consolidated Statements of Changes in Financial Position

	Year Ended June 30,		
(In thousands)	1986	1985	1984
Working capital provided:			
Operations:			
Net income	$39,254	$24,101	$15,880
Depreciation	5,754	3,462	2,068
Other	—	83	(684)
Total from operations	45,008	27,646	17,264
Common stock issued	46,279	368	591
Long-term obligations	1,879	—	848
Total working capital provided	93,166	28,014	18,703
Working capital used:			
Additions to property, plant and equipment	14,108	6,576	5,837
Reduction of long-term debt	—	435	413
Loans to stockholders—net	589	213	534
Translation adjustment	52	602	71
Other	1,407	204	342
Total working capital used	16,156	8,030	7,197
Increase in working capital	$77,010	$19,984	$11,506
Changes in elements of working capital:			
Current assets—increase (decrease):			
Cash and short-term investments	$83,728	$15,666	$ 53
Trade accounts receivable	9,226	1,707	13,518
Inventories	2,089	(3,851)	5,225
Other	871	597	438
Current liabilities—(increase) decrease	(18,904)	5,865	(7,728)
Increase in working capital	$77,010	$19,984	$11,506

See accompanying notes.

Note 1.
Significant Accounting Policies

Business—The Company's principal business activities are the development, production, marketing, and support of microcomputer software and related books and hardware peripheral devices.

Principles of Consolidation—The consolidated financial statements include the accounts of Microsoft and its wholly owned subsidiaries. Significant intercompany transactions and balances have been eliminated.

Revenue Recognition—Revenue from sales of software and hardware consumer products to distributors or retail dealers is recognized when the products are shipped.

Software products are sold to original equipment manufacturers under license agreements which generally provide for a commitment fee payable over a minimum commitment period of one to three years. When the product is accepted, the commitment fee is recognized as revenue ratably over the minimum commitment period or on a per-system or per-copy basis if sales exceed the commitment fee level. Subsequent to the minimum commitment period, revenue based upon the number of systems shipped or copies sold is recognized as earned. Commitment fees received prior to product acceptance are recorded as customer deposits.

Short-term Investments—Short-term investments are carried at cost which approximates market.

Inventories—Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property, Plant and Equipment—Property, plant and equipment is stated at cost and depreciated using straight-line and declining-balance methods over their estimated useful lives. The estimated useful lives are:

Computer equipment	5 years
Office furniture and equipment	5 years
Buildings	35 years
Leasehold improvements	Lease term

Warranties and Exchanges—The Company warrants certain products against certain defects and has policies permitting distributors and dealers to exchange product under certain circumstances. The Company's policies do not permit return of products for credit or refund. The Company's reserve for warranties and exchanges at June 30, 1986 was not significant.

Software Research and Development Costs—The majority of the Company's products are developed internally. Costs related to research and development and to production of software product masters are expensed as incurred. In August 1985 the Financial Accounting Standards Board issued a statement requiring capitalization of certain costs of producing software product masters beginning in the Company's year ending June 30, 1987. Had these new guidelines been applicable to the accompanying consolidated financial statements, income from operations may have been higher than amounts reported by an indeterminable amount.

Cost of revenues includes royalties paid to authors of certain software products made under license agreements. Such royalties, which are based on net revenues, were $5,345,000, $3,736,000, and $2,801,000 for the years ended June 30, 1986, 1985, and 1984.

Non-operating Income—Non-operating income includes interest income of $3,197,000, $952,000, and $427,000 for the years ended June 30, 1986, 1985, and 1984. In 1986 the Company realized a foreign currency transaction gain of $2,015,000 resulting primarily from the repayment of debt from certain international subsidiaries. In 1985 the Company realized a short-term capital gain of $984,000 upon the sale of marketable equity securities, and in 1984 the Company realized a short-term capital loss of $1,500,000 from the write-off of the entire value of a minority interest in a closely held company.

Income Taxes—Certain items of income and expense included in the consolidated financial statements are reported in different years in the tax returns in accordance with applicable income tax laws. The resulting difference between the consolidated financial statement income tax provision

Note 1 (continued)

and income taxes currently payable is reported in the consolidated financial statements as deferred income taxes. Investment and other tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable (flow-through method).

Foreign Currency Translation—Assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Revenues, costs, and expenses are translated using an average rate. Translation adjustment is shown separately in stockholders' equity.

Net Income Per Share—Net income per share is computed on the basis of the weighted average number of common and common equivalent shares outstanding and is adjusted for the assumed conversion of preferred shares and shares issuable upon exercise of stock options. The computation assumes the proceeds from the exercise of stock options were used to repurchase common shares at the average market price of the Company's common stock during each period. Prior to the Company's initial public offering of its common stock in March 1986, the market price of the common stock was determined by independent appraisal.

Note 2.
Inventories

Inventories at June 30, 1986 and 1985 were as follows:

(In thousands)	June 30, 1986	1985
Raw materials	$3,626	$2,166
Work in process	444	339
Finished goods	3,938	3,414
	$8,008	$5,919

Note 3.
Property, Plant and Equipment

Property, plant and equipment at June 30, 1986 and 1985 was as follows:

(In thousands)	June 30, 1986	1985
Computer equipment	$18,593	$11,574
Office furniture and equipment	7,164	4,306
Buildings	1,879	—
Leasehold improvements	2,944	2,260
	30,580	18,140
Less accumulated depreciation	11,036	6,950
Property, plant and equipment—net	$19,544	$11,190

In May 1986 the Company exercised its option to purchase approximately 20 acres of undeveloped land adjacent to its current leased facilities in Redmond, Washington (see Note 5). The purchase, expected to close in August 1986, is priced at approximately $5,000,000.

Note 4.
Income Taxes

The income tax provision (benefit) is composed of:

(In thousands)	1986	1985	1984
Current	$30,949	$17,363	$11,549
Deferred	(4,219)	1,379	601
	$26,730	$18,742	$12,150

The deferred income tax provision (benefit) is composed of:

(In thousands)	1986	1985	1984
Cash basis tax accounting	$(2,659)	$ 2,309	$ 2,270
Reserves and expenses currently not deductible	(871)	104	(538)
Inventory adjustment	(705)	(714)	(850)
DISC	—	(282)	(12)
Other—net	16	(38)	(269)
	$(4,219)	$ 1,379	$ 601

The Company's effective tax rate differs from the federal rate as follows:

	1986		1985		1984	
(Dollars in thousands)	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income
Federal income taxes at statutory rate	$30,353	46.0%	$19,708	46.0%	$12,893	46.0%
State income taxes, net of federal tax benefit	632	1.0	1,194	2.8	500	1.8
Unrealized (realized) tax benefit of foreign operating losses	(1,005)	(1.5)	516	1.2	534	1.9
Unrealized (realized) tax benefit of capital loss carryforward	—	—	(453)	(1.1)	690	2.5
Tax benefit of manufacturing operations in Ireland	(805)	(1.2)	—	—	—	—
Tax exempt non-operating income	(900)	(1.4)	—	—	—	—
DISC/FSC benefit	(1,319)	(2.0)	(1,247)	(2.9)	(1,754)	(6.3)
Tax credits	(923)	(1.4)	(2,007)	(4.7)	(1,368)	(4.9)
Other—net	697	1.0	1,031	2.4	655	2.3
	$26,730	40.5%	$18,742	43.7%	$12,150	43.3%

In 1984 the Company reversed Domestic International Sales Corporation (DISC) deferred taxes as a result of Federal legislation to permanently exempt certain DISC earnings from taxation.

At June 30, 1986 the Company had capital loss carryforwards of $510,000 which expire in 1989 and unused foreign operating loss carryforwards of $895,000, available to offset future foreign taxable income, which expire as follows: 1990, $220,000; 1991, $46,000; 1992, $322,000; indefinitely, $307,000.

In the course of a current examination of the years ended June 30, 1983 and 1984 by the Internal Revenue Service, a field agent has proposed that the Company is subject to the personal holding company ("PHC") tax. The PHC penalty tax applies to a corporation that meets two tests: (1) more than 50% of the outstanding stock is owned by five or fewer individuals, and (2) at least 60% of its adjusted ordinary gross income, as defined in Section 543 of the Internal Revenue Code, is from passive sources such as interest, dividends, rents, and royalties. The law was designed to discourage the accumulation of passive income by closely held corporations and is generally not applied to active operating corporations. However, in September 1984 the Internal Revenue Service issued a private letter ruling holding that income from license fees and maintenance fees received by a developer of custom software which it licensed, relying on trademark and trade-secret protection, to a limited number of large companies and governmental agencies was "personal holding company income" under Section 543 of the Internal Revenue Code. The Company meets the stock ownership requirement. However, the Company believes that its business significantly differs from the corporation discussed in the private letter ruling and that its retail sales of mass-produced packaged software products are sales of tangible personal property and should not be classified as PHC income.

The PHC tax is 50% of after-tax income and through June 30, 1986 could be as much as approximately $37,000,000 plus interest. At its option, a corporation subject to the PHC tax may declare a "deficiency dividend," payable to its stockholders of record at the time such a dividend is declared, in an amount equal to the corporation's undistributed PHC income. For the Company this could be as much as approximately $74,000,000 as of June 30, 1986. The payment of a deficiency dividend avoids a PHC tax to the corporation (but not the related interest) but is taxable to the shareholders. If a PHC tax were to be assessed and the Company elected to pay the tax, the payment of tax would be recorded as a charge to operations and would reduce net income accordingly. If a PHC tax were to be assessed and the Company elected to declare a deficiency dividend, retained earnings would be reduced by the amount of such a dividend.

The tax reform bills passed by the House of Representatives in December 1985 and by the Senate in June 1986 each contain a safe-harbor provision specifically for software royalty income. The House and Senate bills are virtually identical in their treatment of software royalty income, except that the Senate bill has retroactive effect and contains a provision relating to foreign PHCs. The

Note 4 (continued)

House–Senate conference committee has agreed upon a compromise version of the tax reform bill which incorporates the Senate version of the safe-harbor provision for software royalty income. The compromise version must be approved by both the House and the Senate and then be submitted to the President for his approval. If passed, the proposed change would remove the Company from PHC status. Regardless of whether corrective legislation is passed and regardless of whether such legislation is retroactive, the Company believes that its retail sales are greater than 40% of adjusted ordinary gross income for all significant periods through June 30, 1986 and that such sales are not PHC income, and intends to vigorously contest any PHC tax assessment.

Although management and counsel presently believe that there is a small risk that the Company might have to either pay the PHC tax or declare a deficiency dividend, they believe that it is more likely than not that neither payment of a material tax nor a material deficiency dividend will be required.

Note 5. Leases

The Company has operating leases for corporate campus facilities, domestic manufacturing and distribution warehouses, field sales offices, and data processing and other equipment. The noncancelable, corporate campus facilities lease expires in 2001 with renewal options through 2011. Rental expense was $4,533,000, $3,012,000, and $2,373,000 during the years ended June 30, 1986, 1985, and 1984.

In addition, the Company has capital leases for certain manufacturing, warehouse, and general office facilities. At June 30, the following item under capital leases was included in property, plant and equipment:

	June 30,	
(In thousands)	1986	1985
Buildings	$1,879	—
Less accumulated depreciation	—	—
Net	$1,879	—

At June 30, 1986, future minimum lease payments for capital leases and future minimum rental payments under noncancelable operating leases were:

(Dollars in thousands)	Capital Leases	Operating Leases
1987	$ 57	$ 5,584
1988	57	3,925
1989	121	3,096
1990	124	2,911
1991	233	3,426
1992 and thereafter	4,938	26,151
Total minimum payments	5,530	$45,093
Less amount representing interest	3,651	
Present value of minimum lease payments	$1,879	

Note 6. Stockholders' Equity

Authorized Capital and Common Stock Split—During 1984 the number of shares of authorized $.001 par value common stock was increased from 20,000,000 to 60,000,000 and a 2-for-1 common stock split was effected in the form of a stock dividend. All share and per share information has been restated to give effect to the stock split.

Preferred Stock—Preferred stock converted into 1,000,000 shares of common stock automatically upon sale of the Company's common stock in its public offering in March 1986.

Employee Stock Purchases—Other assets included 7% loans to stockholders of $724,000 and $736,000 at June 30, 1986 and 1985 originally made to employees to enable them to pay personal income taxes arising from the purchase of common stock at prices below fair value as independently appraised. Stock purchase agreements with these employees provide the Company with the right of first refusal to repurchase employees' shares. During the years ended June 30, 1986 and 1985, 60,500 and 58,335 shares of common stock were issued to employees at independently appraised fair values for 9% notes receivable of $753,000 and $175,000. Payments under these notes, due from 1991 to 1993, will be credited to paid-in capital as received.

Employee Stock Purchase Plan—In January 1986 the Company established an employee stock purchase plan for all employees. Employees may contribute up to 10% of their compensation to

Note 6 (continued)

purchase the Company's common stock at 85% of fair market value. The Plan commenced in July 1986 and will terminate December 1990. The Company has reserved 300,000 shares of common stock for the plan.

Stock Option Plan—The Company has a stock option plan for officers and key employees which provides for nonqualified and incentive options. The Board of Directors determines the option price (not to be less than fair market value for incentive options) at the date of grant. The options generally expire five years from the date of grant and are exercisable over the period stated in each option.

	Reserved Shares	Outstanding Options	
		Number	Price per Share
Balance, June 30, 1983	3,019,000	1,377,256	\$.475- 1.50
Granted	—	733,615	\$1.50- 3.00
Exercised	(72,692)	(72,692)	\$.475- 1.50
Expired	—	(109,464)	\$.475- 3.00
Balance, June 30, 1984	2,946,308	1,928,715	\$.475- 3.00
Granted	—	652,715	\$3.00
Exercised	(214,153)	(214,153)	\$.475- 3.00
Expired	—	(219,726)	\$.475- 3.00
Balance, June 30, 1985	2,732,155	2,147,551	\$.475- 3.00
Additional shares reserved	1,400,000	—	—
Granted	—	1,232,765	\$3.00-34.00
Exercised	(604,766)	(604,766)	\$.475- 5.50
Expired	—	(266,006)	\$.475-32.25
Balance, June 30, 1986	3,527,389	2,509,544	\$.475-34.00

Of the options granted during the year ended June 30, 1986, 195,000 were nonqualified options. All other options granted were incentive options.

At June 30, 1986, options for 425,900 shares were exercisable and 1,017,845 shares were available for future grants under the Plan.

Note 7.
Business Segment and Foreign Operations

The Company operates in one business segment—the development, production, marketing, and support of microcomputer software and related books and hardware peripheral devices.

Information concerning geographic areas for the years ended June 30, 1986, 1985, and 1984 is summarized in the following table.

(In thousands)	Domestic Operations	European Operations	Other Foreign Operations	Eliminations	Consolidated
1986					
Net revenues:					
Unaffiliated customers	\$161,287	\$28,087	\$ 8,140	\$ —	\$197,514
Affiliates	19,152	9,979	1,248	(30,379)	—
Total	\$180,439	\$38,066	\$ 9,388	\$(30,379)	\$197,514
Income from operations	\$ 55,353	\$ 6,151	\$ 1,015	\$ (1,613)	\$ 60,906
Identifiable assets	\$169,230	\$27,830	\$12,837	\$(39,158)	\$170,739
1985					
Net revenues:					
Unaffiliated customers	\$123,777	\$14,066	\$ 2,574	\$ —	\$140,417
Affiliates	13,807	3,081	24	(16,912)	—
Total	\$137,584	\$17,147	\$ 2,598	\$(16,912)	\$140,417
Income from operations	\$ 42,937	\$ 125	\$ (503)	\$ (1,652)	\$ 40,907
Identifiable assets	\$ 71,163	\$ 9,294	\$ 2,825	\$(18,218)	\$ 65,064
1984					
Net revenues:					
Unaffiliated customers	\$ 90,473	\$ 5,998	\$ 1,008	\$ —	\$ 97,479
Affiliates	7,572	1,452	97	(9,121)	—
Total	\$ 98,045	\$ 7,450	\$ 1,105	\$ (9,121)	\$ 97,479
Income from operations	\$ 29,204	\$(1,023)	\$ (146)	\$ 1,068	\$ 29,103
Identifiable assets	\$ 49,093	\$ 7,440	\$ 712	\$ (9,608)	\$ 47,637

Note 7 (continued)

Domestic operations—net revenues from unaffiliated customers includes export sales of $43,756,000, $27,972,000, and $22,469,000 during the years ended June 30, 1986, 1985, and 1984. These export sales were made primarily to Europe and the Far East. Other foreign operations include subsidiaries in Australia, Canada, and Japan.

Transfers to affiliates are made at market prices less an allowance for marketing and advertising expenditures.

Cost of revenues includes commissions of $5,070,000, $5,179,000, and $4,377,000 during the years ended June 30, 1986, 1985, and 1984 paid to a foreign company whose major stockholder is a former director of the Company. The Company has terminated its relationship with this foreign company.

Note 8.
Litigation

The Company was served in January 1986 with a summons and complaint in an action commenced by Seattle Computer Products, Inc. ("SCP") in the Superior Court for King County, Washington. The Company has served and filed its answer and counterclaims and both sides have begun discovery. A trial date for the declaratory relief aspect of the case (see item (i) below) has been set for November 1986. This action arises out of an agreement entered into in 1981 under which SCP sold to the Company SCP's rights in a disk operating system which the Company developed into MS-DOS. SCP seeks the following relief: (i) a judicial declaration that under the agreement SCP has an assignable, perpetual, royalty-free worldwide license from the Company for MS-DOS in its current and future versions; (ii) an injunction against the Company prohibiting alleged interference with SCP's attempts to sell its business and requiring the Company to honor SCP's interpretation of the agreement; and, in the alternative, (iii) judgment against the Company for damages "believed to exceed $20,000,000" or $60,000,000 when trebled or a rescission of the agreement, a return of all rights granted thereunder, and an accounting for and payment to SCP of all revenues received from the Company's marketing of MS-DOS. The Company and counsel believe that SCP's interpretation of the agreement is erroneous and the Company intends to vigorously defend this action. Although the outcome of litigation can never be predicted with certainty, the Company and counsel further believe that it is unlikely that SCP could obtain the relief sought with respect to any of the substantive aspects of the case.

Note 9.
Quarterly Financial and Market Information (Unaudited)

(In thousands, except per share data)	Quarter Ended Sept. 30	Dec. 31	Mar. 30	June 30	Year
1986					
Net revenues	$35,153	$49,897	$50,505	$61,959	$197,514
Income from operations	9,964	16,688	15,394	18,860	60,906
Net income	6,170	10,948	10,629	11,507	39,254
Net income per share	.26	.46	.42	.42	1.56
Common stock prices:					
High	—	—	29¾	35½	35½
Low	—	—	25½	26¾	25½
1985					
Net revenues	$26,004	$36,833	$40,662	$36,918	$140,417
Income from operations	7,093	10,725	15,339	7,750	40,907
Net income	3,962	6,034	8,497	5,608	24,101
Net income per share	.17	.26	.37	.24	1.04

The Company has never paid cash dividends on its common stock. The Company presently intends to retain earnings for use in its business and therefore does not anticipate paying any cash dividends in the foreseeable future.

The Company's common stock has been traded on the NASDAQ National Market System since its initial public offering in March 1986. On July 31, 1986, there were 2,879 holders of record of the Company's common stock.

To the Shareholders of Microsoft Corporation:

We have examined the consolidated balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1986 and 1985, and the related consolidated statements of income, stockholders' equity, and changes in financial position for each of the three years in the period ended June 30, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such consolidated financial statements present fairly the financial position of Microsoft Corporation and subsidiaries at June 30, 1986 and 1985 and the results of their operations and the changes in their financial position for each of the three years in the period ended June 30, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins + Sells

Bellevue, Washington
July 31, 1986

Directors and Officers

Directors	William H. Gates	Chairman of the Board and Chief Executive Officer, Microsoft Corporation
	Jon A. Shirley	President and Chief Operating Officer, Microsoft Corporation
	David A. Marquardt	Partner, Technology Ventures Investors
	Portia Isaacson	Chairman and Chief Executive Officer, Intellisys Corporation
Officers	William H. Gates	Chairman of the Board and Chief Executive Officer
	Jon A. Shirley	President and Chief Operating Officer
	Scott A. Oki	Senior Vice President, USA Sales and Marketing
	Steven A. Ballmer	Vice President, Systems Software
	Jeremy Butler	Vice President, International Operations
	Francis J. Gaudette	Vice President, Finance and Administration; Treasurer; Chief Financial Officer
	James W. Harris	Vice President, OEM Sales
	Thomas M. Lopez	Vice President, CD ROM Software
	William H. Neukom	Vice President, Law and Corporate Affairs; Secretary
	Jean D. Richardson	Vice President, Corporate Communications

Form 10-K	Copies of Microsoft's Annual Report on Form 10-K are available upon written request from the Investor Relations Department, Microsoft Corporation, 16011 NE 36th Way, Box 97017, Redmond, Washington 98073-9717
Common Stock	Microsoft common stock is traded over the counter on the NASDAQ National Market System (MSFT)
Independent Accountants	Deloitte Haskins & Sells, Bellevue, Washington 98004
Legal Counsel	Shidler McBroom Gates & Lucas, Seattle, Washington 98104
Transfer Agent	First Jersey National Bank, Watermark Tower, 1109 First Avenue, Suite 306, Seattle, Washington 98101

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